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THE BUSINESS PURPOSE DOCTRINE AND THE LIMITS OF EQUAL TREATMENT IN CORPORATION LAW

by
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IN the law of corporations, the business judgment rule provides that absent special circumstances the courts will not second-guess decisions of corporate officers and directors. When special circumstances, such as self-dealing, failure to manage, lack of any valid business purpose, or irrationality prevail, the courts will review management decisions and shift the burden of justifying the decision to the manager.[1] The rationale for the rule is simple: corporate managers are in the best position to exercise discretion relating to the conduct of business. To second-guess corporate decision makers from the insular position of the courts would unduly limit the range of decisions open to managers by increasing the risk of shareholder challenge.[2]

Self-dealing is no doubt the best known exception to the business judgment rule. In its simplest form, self-dealing may consist of a director's sale of a piece of property to the corporation.[3] The obvious danger in such sales is that the director will have overcharged or foisted a useless item on the corporation. When no such conflict of interest is present, the courts presume that the director is acting in the best interests of the corporation.[4]

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1. The business judgment rule is codified in many states. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (1982). *See generally* 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1040-1041, 1295 (perm. ed. 1975); E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75-77, 86-88 (1972); Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 97 (1979). The term "manager" is used herein to include both officers and directors.

2. *See* Arsht, *supra* note 1, at 95-100; *infra* note 160 and accompanying text.

3. *See* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548, 554 (Sup. Ct. 1963).

4. Self-dealing is often very difficult to detect. *See* V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 622 (2d ed. 1979); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 340-44 (1974). Nevertheless, the business judgment rule by its very nature requires that the plaintiff point to particular facts that tend to show an abuse, not merely circumstances indicating an opportunity for abuse. *See* Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

When such a conflict exists, however, the question arises as to whose interest is being pursued.[5] In such cases, the courts are willing to review the fairness of the transaction.[6] The transaction is not prohibited, however, because it may be in the interest of both parties.

Nevertheless, in some self-dealing cases, particularly those relating to defensive maneuvers in takeover battles, proxy fights, dividend declarations, and until recently, parent-subsidiary mergers, the courts allow defendants to skirt the burden of justifying decisions by requiring only that some business purpose be shown for the transaction in question.[7] Yet the corporate manager undoubtedly benefits personally in these cases both monetarily and otherwise. Even though the plaintiff has shown self-dealing, if the manager has shown a proper business purpose, the plaintiff may still be required to bear the much heavier burden of proving that no business purpose exists.[8]

Moreover, the courts do not generally require that the manager's proper purpose be balanced against the personal benefit to the manager, but require only that a purpose be shown.[9] Why does the burden in some cases shift back to the plaintiff to prove that any relief at all should be granted? Aside from the fact that nonmonetary relief is usually more difficult for a plaintiff to obtain,[10] it is unclear why in these circumstances the manager, who is a fiduciary, is given the benefit of the doubt. Indeed, he will almost certainly be able to accomplish the planned transaction at some price, rather than being held to a rigid duty not to benefit personally at shareholder expense.[11]

As with the straightforward example of a director's sale of property, the manager does not always benefit at the shareholders' expense when the business purpose test is applied. While the manager invariably does benefit by his use of corporation property, facilities, and power (by remaining in control or by choosing a dividend policy advantageous to himself, for example), the shareholder does not invariably lose. The corporation may

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5. The question almost always is present, however. *See* Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980); *infra* text accompanying note 46.

6. "Fairness" is generally defined as what would have happened if arm's-length bargaining had taken place. E. FOLK, *supra* note 1, at 86-88.

7. For examples, see *infra* notes 22-33, 40-41 (defensive maneuvers), 34-39 (proxy fights), 99-104 (dividend declarations), 74-93 (freeze-outs), and accompanying text.

8. *See* Arsht, *supra* note 1, at 107-08, 132-33.

9. Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980). This approach does not mean that the monetary fairness of such transactions will not be scrutinized when possible. For example, until recently in Delaware the fairness of interested mergers was reviewed even though a business purpose had already been shown. *See infra* notes 74-90 and accompanying text. When the issue is not an immediately monetary one, however, as in a proxy fight, it is difficult to find anything to scrutinize. *See infra* notes 53-59 and accompanying text. In such cases the only possible relief appears to be injunctive.

10. Indeed, equitable relief is generally considered available only if the plaintiff has no adequate remedy at law, that is, if the plaintiff cannot be made whole by an award of money damages. *See* 11 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2942 (1973).

11. *See, e.g.*, Roland Int'l Corp. v. Najjar, 407 A.2d 1032, 1034 (Del. 1979). *But see* Young v. Valhi, Inc., 382 A.2d 1372, 1374 (Del. Ch. 1978).

in fact be better off under current management than it would be under new management after a take-over battle or proxy fight.[12] The problem, of course, is that a results-oriented test will not do. The legal decision must usually be made before the outcome of the struggle is known, and since in those instances the decision affects the outcome, what would have been will never be known.[13]

Some commentators have argued for a rule of strict equal treatment in business purpose cases in which such a rule could apply. For example, in connection with freeze-out mergers, in which the outside shareholder is forced to take cash while the inside shareholder keeps his stock, some commentators have argued that equal treatment is so fundamental a value in corporation law that in certain circumstances these mergers should be banned altogether, even though they can be accomplished within the letter of the law.[14] In a closely related area, some commentators contend that a controlling shareholder should not be permitted to sell his shares for more than market price unless the opportunity is afforded pro rata to all the shareholders.[15] Yet almost without exception the courts have rejected the rule of equal treatment, often with the unsupported explanation that insiders have some right to exercise control for selfish reasons.[16]

In other applications of the business purpose doctrine, notions of equal treatment apply, but with strange consequences. In the proxy contest area, one commentator has suggested that insiders pay their own expenses or that the corporation pay everyone's expenses.[17] The prevailing rule is

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12. This proposition seems self-evident, but many commentators argue that the ability of management to oppose take-overs by nonmonetary means (or indeed any means) should be severely curtailed or even prohibited. *See infra* note 62.

13. Instances do occur in which preliminary relief is denied and the litigation takes long enough that hindsight may be applied. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497, 508 (Del. 1981). The resemblance to Heisenberg's Uncertainty Principle that the observation of an event alters the event itself must be acknowledged, though no evidence that corporations obey the laws of physics has been found.

14. Brudney, *A Note on Going Private*, 61 VA. L. REV. 1019, 1022-23 (1975); Brudney & Chirelstein, *A Restatement of Corporate Freeze-Outs*, 87 YALE L.J. 1354, 1367 (1978). Interestingly, these authors argue that business purpose is irrelevant in freeze-out mergers, but they distinguish between permissible mergers between a parent and subsidiary and impermissible mergers carried out by forming a shell corporation. They argue that the former may result in real economic gains ("synergy"), while the sole significant motivation for the latter is to get rid of the outside shareholders. The distinction is precisely the one that the business purpose test originally contemplated, *see* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548, 554-55 (Sup. Ct. 1963), although the test may arguably mean something quite different in connection with freeze-outs. *See infra* text accompanying notes 81-90.

15. The literature on this thesis is aptly summarized in W. CARY & M. EISENBERG, CORPORATIONS 511-13 (5th ed. abr. 1980). The most notable case in which the issue arose was Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955). The essential similarity between freeze-out and sale of control cases, though not generally noted, is apparent if one thinks in terms of the majority shareholders' appropriation of an opportunity. *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 345-46 (1974); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 715-30 (1982).

16. *See* W. CARY & M. EISENBERG, *supra* note 15, at 511-13; *infra* text accompanying notes 103-15. Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955), is one of the few exceptions, and is an equivocal one.

17. *See* Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1491 (1970).

firmly in favor of insiders; as long as the controversy relates to business policy, insiders may cause the corporation to pick up the tab even though incidentally, or not so incidentally, the insiders thereby perpetuate their control.[18] Except for the prevailing use of the word "policy" instead of "purpose," the standard in the area of proxies is clearly the business purpose test.

The requirement of equal treatment is strongest with respect to dividends, because no exceptions exist. In a sense, however, the shareholder typically decries equal treatment. He is forced to take or forgo dividends at the discretion of insiders, who may, either primarily or incidentally, be serving their own interests.[19] When no inequality of treatment is present, no self-dealing in the ordinary sense exists. Business purpose is the kind of exception that must apply, but the question is how payment of a dividend serves a business purpose anyway.

The central issues in this discussion of self-dealing transactions are why such transactions are subject to differing standards of evaluation, and how a plaintiff is to identify the potentially protected self-dealing transaction. In each case, except in an interested merger, the common feature is that a single solution must be chosen. Only one group may manage, and only one dividend policy may be followed. In a typical self-dealing case the transaction in question is not necessary. This distinction suggests that the business purpose test applies in circumstances in which avoiding deadlock is important.[20]

This Article concludes that good reasons ultimately justify protection of certain selfishly motivated uses of control. These reasons lie in the very nature of the corporation and are intimately related to the corporate characteristics of perpetual existence, limited liability of shareholders, management by a board of directors, and standardized equity participation through share certificates.[21] Further, it appears that a reliable and general rule describing permissible behavior in these transactions cannot be formulated. Business purpose seems to be a concept that is defined by stating what it is not. It should not, therefore, be expected to provide a positive standard appropriate to affirmative proof by defendant managers.

I. THE BUSINESS PURPOSE DOCTRINE AND CONTESTS FOR CONTROL

The place of business purpose in the review of corporate decisions first emerged in a Delaware case, *Cheff v. Mathes*.[22] In *Cheff* the company was

18. *See infra* notes 34-38 and accompanying text.

19. *See infra* notes 95-102 and accompanying text.

20. *See infra* notes 145-49 and accompanying text; Brudney & Chirelstein, *supra* note 15, at 325-26; Brudney & Chirelstein, *supra* note 14, at 1356-57; Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1054-55 (1981).

21. While the business judgment rule does apply in the partnership context, the business purpose test does not apply, because decisions regarding such fundamental concerns as require alteration of the partnership agreement must be made unanimously in the absence of an agreement to the contrary. UNIFORM PARTNERSHIP ACT § 18(h) (1914) [hereinafter cited as UPA]; *see* A. CRANE & A. BROMBERG, LAW OF PARTNERSHIP 381-82 (1968).

22. 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964). *Cheff v. Mathes* was not, however,

threatened with take-over by a purchaser who, in the view of the directors, intended either to liquidate the company or to drastically alter its business practices.[23] In order to stave off this attack, the company repurchased some of its own shares on the open market and finally bought at a modest premium the block that had been acquired by the attacker. This transaction was then challenged by a minority shareholder, who argued that the directors had caused the corporation to repurchase the shares in order to preserve their jobs. The plaintiff charged that the repurchases were in fact self-dealing transactions and that the price paid by the corporation was unfair since it was in excess of the stock's current market price.

The court distinguished the conflict of interests that the directors of the company had from those of the president and the company's attorney.[24] The court held that both were required to justify their actions, but that the burden on the directors was considerably lighter since the directors' personal interest in the transactions (as substantial shareholders) was much the same as that of any shareholder.[25] The president and the attorney, on the other hand, could have been motivated by their desire to keep their salaried jobs. The court held that the business judgment rule did not protect the transaction from challenge, but decided that the officers had met their burden of proof by showing a legitimate reason for the transactions and by demonstrating the decision had been made in good faith and after reasonable investigation.[26] The court also said that the officers should not be penalized for an honest mistake in judgment.[27]

Though it alluded to the problem, the court did not explain how strongly the officers must believe in a threat to the company's business practices when the officers are motivated simultaneously by a desire to keep their positions.[28] Although it would be difficult to quantify the effect

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sui generis. The origins of the doctrine can be traced back at least fifty years, though before *Cheff v. Mathes* a distinctive rule was not set down. *See* Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962); Martin v. American Potash & Chem. Corp., 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952); Kors v. Carey, 158 A.2d 136 (Del. Ch. 1960); Bennett v. Brueil Petroleum Corp., 34 Del. Ch. 6, 99 A.2d 236 (1953); Yasik v. Wachtel, 25 Del. Ch. 247, 17 A.2d 309 (1941); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 A. 226 (1934); Anderson v. Albert & J.M. Anderson Mfg. Co., 325 Mass. 343, 90 N.E.2d 541 (1950). In each case the action challenged was plainly legal, but for the threat of takeover.

23. 199 A.2d at 551-52.

24. *Id.* at 554.

25. *Id.*; *see* Smith v. Good Music Station, Inc., 36 Del. Ch. 262, 129 A.2d 242 (1957); *infra* note 135. The court noted in another context, however, that it was well known that a large block of shares would sell for more than market price because of their attendant control. 199 A.2d at 555. Thus the plaintiff could have argued that the nonofficer directors did have a pecuniary interest unlike that of a typical shareholder, namely, the premium they might be able to command as controlling insiders.

26. *Id.* at 554-55. The decision seems to suggest that the rule arises under a director's duty of care more than under his duty of loyalty. *See* Arsht, *supra* note 1, at 115-21.

27. 199 A.2d at 555.

28. *Id.* at 554-55. To a certain extent, "motive" and "purpose" are terms of art in Delaware. *See* Abercrombie v. Davies, 36 Del. Ch. 371, 130 A.2d 338, 344 (Sup. Ct. 1957). "Motive" usually refers to the actual reasons for a transaction, while "purpose" indicates focus on the formal reasons or the effect. As noted in *Cheff*, the rule of Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962), is that when the motive is unacceptable a proper

of the two motivations, the court seemed quite careful not to say that the repurchases were motivated primarily by one or the other concern. If the belief that the attacker would change the company's business practices need only be genuinely held, even if it pales in importance beside the officers' desire to keep their jobs, the rule set down in *Cheff* differs little from the business judgment rule. Although proving the existence of a business purpose is the burden of the defendant officers, that burden is very light.[29]

Delaware courts first interpreted business purpose quite narrowly. In *Condec Corp. v. Lunkenheimer Co.*[30] the Delaware chancery court held that a board's decision to oppose a tender offer, by issuance of a swing block of shares to a "white knight," was made without sufficient investigation into the merits of the take-over offer.[31] The chancery court found no evidence that the aspirant to control would alter significantly the business of the target and ordered the newly issued shares cancelled.[32] Although the target raised several apparently valid reasons for its actions in opposition, the court seemed to interpret *Cheff v. Mathes* to require some showing of likely damage to the corporation's business. Since this episode, however, the courts have taken an increasingly expansive view of business purpose in connection with the purchase or issuance of shares or any sort of defense against a take-over attempt.[33]

The issue in *Cheff* is functionally similar to that raised by a proxy con-

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purpose cannot save the transaction. The reader is invited to come to his own conclusions about the efficacy of this distinction.

29. Note, however, that the burden is necessarily the defendant's; the plaintiff cannot be expected to prove that insiders had no purpose other than to preserve their offices. *See* Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977).

30. 230 A.2d 769 (Del. Ch. 1967).

31. *Id.* at 776. The term "white knight" refers to a company that purchases a target that is being threatened by takeover by a company that, for some reason, is seen as an undesirable new owner.

32. 230 A.2d at 776.

33. *See* Kaplan v. Goldsamt, 380 A.2d 556, 568 (Del. Ch. 1977); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975); Ward Foods, Inc. v. Lambert (Del. Ch. 1972), *reported in* 1 DEL. J. CORP. L. 137, 144-45 (1976); *see also* Herald Co. v. Seawell, 472 F.2d 1081, 1096 (10th Cir. 1972) (court will not impose its business judgment on management unless facts are compelling); McPhail v. L.S. Starrett Co., 257 F.2d 388, 394 (1st Cir. 1958) (only in extreme case will court substitute its judgment for those so charged); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969) (because a wide measure of discretion is given those in control, mere differences of judgment are insufficient for judicial intervention); Tallant v. Executive Equities, Inc., 232 Ga. 807, 209 S.E.2d 159, 161 (1974) (courts will not interfere in business matters merely involving management's discretion); Cummings v. United Artists Theatre Circuit, Inc., 237 Md. 1, 204 A.2d 795, 803 (1964) (as long as board of directors acts for good of corporation, court will not interpose its judgment). *But see* Chicago Stadium Corp. v. Scallen, 530 F.2d 204, 207 (8th Cir. 1976); Klaus v. Hi-Shear Corp., 528 F.2d 225, 233 (9th Cir. 1975). In addition to a motivation to preserve control, the cases have noted the possibility of other, more profitable uses for the money in cases of issuer repurchases. *See generally* Brudney, *Fiduciary Ideology in Transactions Affecting Corporation Control*, 65 MICH. L. REV. 259, 270-72 (1966); Note, *Buying Out Insurgent Shareholders With Corporate Funds*, 70 YALE L.J. 308, 313-14 (1960).

Two distinct issues are present here: (1) the propriety of stock transactions intended to keep the incumbents in power; and (2) the propriety of purchasing an insurgent's shares at a premium. Both issues involve unequal treatment, but of different kinds. The latter may be thought of as an unequal dividend. *See infra* notes 136-38 and accompanying text.

test, in which a similar sort of self-dealing is common. In *Rosenfeld v. Fairchild Engine & Airplane Co.*[34] the plaintiff challenged the expenditure of corporation money for proxy solicitation made by the defeated management team, apparently on the theory that the expenditures were motivated by the desire of management to perpetuate itself in office. The court held that ordinarily directors may look to the corporation for payment, since holding otherwise would impede the voting process in uncontested cases and unduly favor the insurgents in proxy contests.[35] Thus, in the case of a contest, management was privileged to use corporate funds to make its views known about matters of policy.[36] The court pointed out, however, that in a "purely personal power contest" corporation funds may not be used.[37] Yet, clearly any dispute may be cast in terms of policy. The rule here is the same as in *Cheff*: this sort of self-dealing will be tolerated if minimally justified by reference to policy, that is, business purpose.[38]

The courts have with increasing frequency grappled with the extent to which actions of incumbent management in thwarting hostile take-over attempts should be subject to review. For example, the target company may sell important assets, or it may merge with a competitor of the aspirant and render the proposed acquisition illegal under the antitrust laws.[39] Whether such transactions are wise, in the absence of a take-over bid, is

34. 309 N.Y. 168, 128 N.E.2d 291 (1955).

35. 128 N.E.2d at 292-93.

36. *Id.* at 293.

37. *Id.*; *accord* Levin v. Metro-Goldwyn-Mayer, Inc., 264 F. Supp. 797 (S.D.N.Y. 1967); Kaufman v. Wolfson, 153 F. Supp. 253 (S.D.N.Y. 1957); Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950); Campbell v. Loew's, Inc., 36 Del. Ch. 563, 134 A.2d 852 (1957); Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 A. 226 (1934); Street v. Laclede-Christy Co., 409 S.W.2d 691 (Mo. 1966); Grodetsky v. McCrory Corp., 49 Misc. 2d 322, 267 N.Y.S.2d 356 (Sup. Ct.), *aff'd*, 27 A.D.2d 646, 276 N.Y.S.2d 841 (1966); *see* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL ch. 21 (1957).

38. *See supra* note 17 and accompanying text.

39. *See, e.g.*, Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 102 S. Ct. 658, 70 L. Ed. 2d 631 (1981). The range of defensive tactics as well as opinions concerning their propriety is almost limitless. *See, e.g.*, Cohn, *Tender Offers and the Sale of Control: An Analogue to Determine the Validity of Target Management Defense Measures*, 66 IOWA L. REV. 504 (1981); Gelfond & Sebastian, *Re-Evaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403 (1980); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lipton, *Take-Over Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981); Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980); Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901 (1979); Profusek, *Tender Offer Manipulation: Tactics and Strategies After* Marathon, 36 SW. L.J. 975 (1983); Steinberg, *Fiduciary Duties and Disclosure Obligations in Proxy and Tender Contests for Corporation Control*, 30 EMORY L.J. 169 (1981); Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982); Weiss, *Tender Offers and Management Responsibility*, 23 N.Y.L. SCH. L. REV. 445 (1978); Comment, *Anti-Takeover Maneuvers: Developments in Defense Tactics and Target Actions for Injunctive Relief*, 35 SW. L.J. 620 (1981); Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1066 (1983); Note, *Developments in Corporate Takeover Techniques: Creeping Tender Offers, Lock-Up Arrangements and Standstill Agreements*, 39 WASH. & LEE L. REV. 1095 (1982); Note, *Corporate Director's Liability for Resisting a Tender Offer: Proposed Substantive and Procedural Modifications of Existing State Fiduciary Standards*, 32 VAND. L. REV. 575 (1979). *See infra* notes 61-62.

clearly a question the courts will not ordinarily address under the business judgment rule. Yet in the face of a take-over bid, such transactions may unquestionably be intended to protect existing management. The potential for abuse is evident, but the courts have been reluctant to require anything more than management's demonstration of a business purpose.[40] Indeed, in most cases the courts do not even require a business purpose, but follow the business judgment rule, which is still more favorable to incumbents.[41]

No apparent effort has been made in any of these areas to balance business purpose and personal advantage. Precisely that failing prompted a vigorous and instructive disagreement in the Third Circuit case of *Johnson v. Trueblood*.[42] The case involved a faltering limited partnership and a general partner who consistently opted for remedial measures that would leave him in control. Eventually the venture became bankrupt and the plaintiffs sued the general partner. Faced with the business judgment rule as a defense, plaintiffs argued that the defendant should be liable if perpetuation of control was a motive for defendant's various actions.

Judge Seitz, a former Delaware Chancellor, wrote the majority opinion. In essence the majority opinion held that when control is the alleged motive, the plaintiff must show some sort of bad faith on the part of a business fiduciary.[43] This generally requires that the plaintiff show that retention of control is the sole, or at least primary, motive for defendant's challenged action.[44] As Judge Seitz noted, directors are not ordinary fiduciaries, who are not permitted *any* conflict of interest.[45] Corporate managers operate in conflict of interest as a matter of course. The judge observed that every decision may well be tainted by the director's "desire to keep shareholders satisfied so they will not oust him."[46] In an original formulation, which

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40. *See* Panter v. Marshall Field & Co., 646 F.2d 271, 295 (7th Cir.), *cert. denied*, 102 S. Ct. 658, 70 L. Ed. 2d 631 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980).

41. *See, e.g.*, Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980). The nature of the transactions typically alleged to have been motivated by a desire to perpetuate control often causes conceptual difficulties. Transactions in stock, sales of assets, acquisitions, and the like are undoubtedly protected by the business judgment rule under ordinary circumstances, and a plaintiff who would challenge such a transaction bears the burden of proof. But does the fact that a tender offer has been made or is threatened change the authority of the board to conduct its business? Heightened scrutiny may be appropriate unless something in the transaction negates the need for it. *See* Treadway Cos. v. Care Corp., 638 F.2d 357, 365 (2d Cir. 1980) (sale to white knight inconsistent with motive to preserve control; transaction governed by business judgment rule; burden on plaintiffs). Commentators are very much divided on the propriety of this sort of defense, even though they tend to agree that in the interest of maximizing shareholder wealth other sorts of defenses should be severely curtailed. *See infra* note 62.

42. 629 F.2d 287 (3d Cir. 1980).

43. *Id.* at 293.

44. *Id.*

45. *Id.* at 292.

46. *Id.* Corporate managers are not trustees. Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 514-15 (Sup. Ct. 1939). The reason for this statement is not self-evident, but it implies that circumstances exist in which a trustee would be held to have breached a duty even though a manager would not. *See infra* text accompanying note 59.

may not have survived review in Delaware,[47] Judge Seitz stated that "the business judgment rule seeks to alleviate this problem by validating certain situations that otherwise would involve a conflict of interest for the ordinary fiduciary."[48] When the action is "arguably taken for the benefit of the corporation" the directors are presumed to have acted properly.[49]

Judge Rosenn, in a dissenting opinion, strongly disagreed.[50] He viewed Delaware law as requiring that once a plaintiff shows that retention of control is involved, the burden shifts to the incumbent to show that his action was taken primarily for the benefit of the corporation.[51] The basic rationale of the business judgment rule, he argued, was that the courts should defer to a director's expertise when such expertise is likely to be greater than that of the court, but the justification disappears in the face of actual evidence of a conflict of interest.[52]

The question seems to center on the true rationale for the business judgment rule, or, more precisely, the business purpose rule. Judge Rosenn's formulation has two shortcomings. First, it ignores the fact, pointed out by Judge Seitz, that some motive to control is always present. The standard to be applied should take into account the sort of job the potential defendant has been chosen to do. To the extent to which the job naturally involves conflicts of interest, the expected conflicts do not constitute a valid reason to second-guess the jobholder.[53] Second, Judge Rosenn's formulation assumes that some meaningful comparison between business and personal motivations can be made. Consider the proxy contest case: how could one ever separate a motivation to remain in control from running for office? Yet few, if any, would argue that for the corporation to pay reasonable proxy solicitation expenses for incumbents even when there is a fight going on is prima facie improper.[54]

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47. Delaware courts have been more willing in the recent past to review management's exercise of discretion and, in some cases, to substitute their own. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Sup. Ct. 1981); Fischel, *The Race to the Bottom Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 935-41 (1982). *But see* Block, Prussin & Wachtel, *Dismissal of Derivative Actions Under the Business Judgment Rule:* Zapata *One Year Later*, 38 BUS. LAW. 401 (1983).

48. 629 F.2d at 292.

49. *Id.*

50. *Id.* at 295.

51. *Id.* at 301.

52. *Id.* In a sense, Judge Rosenn's formulation is quite correct: the courts of Delaware do shift the burden when actual evidence of self-dealing, fraud, or the like is introduced. However, Judge Seitz's point was that there was no actual evidence here; rather, the evidence was purely circumstantial. The incumbent had every reason to want to remain in office and gave himself the benefit of every doubt whenever possible. But this does not constitute self-dealing (or fraud or over-reaching) in Delaware. The line is unquestionably a fine one, but Delaware does try to walk it. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983); Stauffer v. Standard Brands, Inc., 187 A.2d 78, 80 (Sup. Ct. 1962) (both requiring that specific improprieties be pleaded in order to state claim challenging an interested merger).

53. Obviously the corporate election process itself is permeated with self-interest. As argued below, however, this may have at least some positive value. *See infra* notes 150-67 and accompanying text.

54. Eisenberg, *supra* note 17; *see* Rosenfeld v. Fairchild Engine & Airplane Co., 309 N.Y. 168, 128 N.E.2d 291, 293 (1955).

The dialogue in *Johnson v. Trueblood* demonstrates that the business purpose rule is no mere contrivance. It reflects a genuine analytical difficulty that arises both from the nature of business and from the common law system that favors money damages over other forms of relief. When a corporate fiduciary sells a parcel of property to the corporation, self-dealing takes place, and the court will review the price.[55] When the action in question involves control, price can be important, but the courts require a far greater showing when a plaintiff seeks relief other than money.[56] In essence the courts require convincing proof that the plaintiff is more entitled to the specific benefit taken than is the defendant.[57] In most cases, however, neither party really deserves to be in control. The courts typically will remain neutral, unless the defendant has committed some breach of faith in addition to seizing and holding on to the indivisible opportunity to control. Seizing the benefit will be tolerated unless it can be shown affirmatively to have injured the enterprise.[58] After all, the controlling position does no one any good unless it is occupied.

The alternative is clearly unacceptable. If personal motivations were to be prohibited and the burden placed on the defendant to prove that his actions were prompted solely, or even primarily, by concern for the corporation, more often than not insurgents would win. Despite an inclination to root for the underdog, a presumption in favor of ousting incumbents is not a sound approach to doing business.[59] Moreover, one should expect

55. *See, e.g.*, Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976); Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942); Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918).

56. *See supra* note 10 and accompanying text.

57. *See* Arsht, *supra* note 1, at 107-08, 132-33. In the typical self-dealing case the issue is essentially whether the manager has been unjustly enriched. Damage to the plaintiff is largely irrelevant; he need only show an "interest" in the transaction. *See, e.g.*, State v. Cortelle Corp., 38 N.Y.2d 83, 341 N.E.2d 223, 378 N.Y.S.2d 654 (1975); Saunders v. Kline, 55 A.D.2d 887 (N.Y. 1977); *see also* RESTATEMENT OF AGENCY § 388 (1933) (agent who profits from transactions made on behalf of principal must return profits to principal); RESTATEMENT (SECOND) OF TRUSTS § 203 (1957) (trustee must return profits arising from administering trust). Thus in some circumstances restitution is often much easier for a plaintiff to obtain. *Compare* Murray v. Standard Pecan Co., 309 Ill. 226, 140 N.E. 834, 836 (1923) (purchaser of stock could not compel issuer to repurchase under unauthorized agreement made by issuer's agent), *with* Seifert v. Union Brass & Metal Mfg. Co., 191 Minn. 362, 254 N.W. 273 (1934) (purchaser of stock may rescind and have restitutuion under unauthorized repurchase agreement). Indeed, plaintiffs sometimes are granted "restitution," in spite of strong arguments that they have not been damaged, in order to rectify the defendant's unjust enrichment effectively. *Compare* Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (complaint need not include allegations of actual damage), *with* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (existence of damages presumed when causation presumed under federal law), *and* Dirks v. SEC, 103 S. Ct. 371, 77 L. Ed. 2d 911 (1983) (plaintiff must prove defendant's improper motive in trading on inside information). The business purpose doctrine tends to apply in situations in which the courts require a showing *both* of damage to the plaintiff and unjust enrichment to the defendant. *See* RESTATEMENT OF RESTITUTION § 3 (1936).

58. *See infra* note 98.

59. Eisenberg, *supra* note 17. Clearly this reasoning does not apply in the case of a trustee, which is precisely the point that Judge Seitz was making in *Johnson v. Trueblood.* Trustees are generally not entitled to their position and cannot engage in any activity in competition with the interest of the beneficiary. RESTATEMENT OF TRUSTS § 170, comment

incumbents to fight in contests for control.[60] The typical justification for shifts in corporate control is that an acquiring entity is willing to pay good money for control because it will put the assets of the corporation to work more profitably. In the case of a tender offer, shareholders will tender if they think the company under current management is not worth as much as is bid. If the offeror bids enough to satisfy a majority of the current shareholders, control will shift. Tendering shareholders, nontendering shareholders, and the economy will all be better off.[61] Many commentators therefore argue that incumbents should not be allowed to take any special steps to retain control.[62]

Simple as this formula is, it is not without difficulties. The argument that management should remain passive is based on the notion that in an efficient market, and in the absence of external distorting forces, a rational public shareholder who is not also an incumbent manager should tender for any premium (or indeed no premium given the opportunitiy to save brokerage commissions), since the chances of doing better by holding on to the stock are no greater than even.[63] According to the argument itself, the decision to tender has nothing to do with the prospects of the target company, whose virtues are already reflected in the market price.

Rational behavior for the shareholder, however, is not necessarily rational behavior for the target company's managers. The managers may

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(b) (1957). In a business good reasons exist to encourage the manager to believe that he has a personal interest in the venture. *Cf.* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1194-97 (1981) [hereinafter cited as Easterbrook & Fischel, *The Proper Role*] (arguing that target company management should acquiesce to tender offer; courts have not adopted this view). *But see* Brudney, *supra* note 14, at 1029-30; Brudney & Chirelstein, *supra* note 15, at 365-68; Brudney & Clark, *supra* note 20, at 1023-24; Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932). The ability to pursue control for selfish reasons, or indeed no well articulated reason at all, may also serve important social functions. *See infra* text accompanying notes 150-67.

60. Rosenfeld v. Fairchild Engine & Airplane Co., 309 N.Y. 168, 128 N.E.2d 291, 292-93 (1955).

61. *See* Easterbrook & Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1740 (1981). Acquirors, it seems, make only normal profits.

62. *See* Bebchuck, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Easterbrook & Fischel, *The Proper Role, supra* note 59; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) [hereinafter cited as *Structural Approach*]. Easterbrook and Fischel argue that management should take no steps to oppose a tender offer since any premium over market price represents a gain to target shareholders and permitting resistance will reduce the total number of tender offers made by increasing the average cost of the transaction itself. Gilson and Bebchuck argue that it should be permissible for target management to seek a higher price from other acquirers, while Easterbrook and Fischel maintain that even this tactic reduces overall shareholder welfare, because the total number of bids is reduced as a result of the disadvantage of bidding first. *See also* Bebchuck, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) [hereinafter cited as *Reply & Extension*] (supporting "auctioneering" in tender offers); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter cited as Easterbrook & Fischel, *Sunk Costs*] (arguing in favor of facilitating competing tender offers); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982) [hereinafter cited as *Seeking Competitive Bids*] (arguing against defensive tactics); *supra* note 39.

63. *See* Easterbrook & Fischel, *The Proper Role, supra* note 59, *passim*.

legitimately disagree with the beliefs of the average trader. After all, only management can know for sure what its strategy is. While the market in effect sets the odds, just as in parimutuel betting, management is in a very good position to know whether the bet should be made. Defensive tactics are readily justifiable if the stock market is efficient, since under such conditions the perceptions of shareholders and managers can legitimately diverge.[64]

Moreover, premiums offered in tender offers are often substantial.[65] It appears that market price does not accurately reflect what most shareholders think their stock is worth, since a tender offer at a premium above market price may still be priced too low to induce half of the shareholders to tender.[66] Even if the offer does succeed, it will not have been enough to

64. Most would no doubt ultimately agree with this thesis if it could be shown that defensive tactics are usually undertaken to protect opportunities that are somehow incapable of being disclosed, either because they are inchoate or because they would be appropriated. Defensive tactics may be a target's way of protecting information about business prospects that has leaked as far as a potential acquiror, but not into the market. While Professors Easterbrook and Fischel argue that defensive tactics unduly discourage first bidders because they increase the riskiness of investment in investigating targets, *id.* at 1178-79, one could as well argue that if defensive tactics were prohibited, target companies would be unduly discouraged from direct investment in projects difficult to keep secret. *See supra* note 62. This factor is suggested, though not precisely addressed, in the dialogue between Professors Easterbrook and Fischel and Martin Lipton. *See* Easterbrook & Fischel, *supra* note 61; Lipton, *supra* note 39.

Surely some tender offers are resisted because of the threat that opportunities will be obtained at bargain prices and because the target's management recognizes this even though the public does not. One certainly would think that managers are the quickest to recognize opportunities. This explanation is at least a more likely one than the explanation that managers behave irrationally in opposing tender offers. The question is: Is resistance undertaken for such reasons or is it prompted primarily by management's desire to perpetuate itself in office? The question *is* the business purpose test. To suggest that the question should automatically be answered one way or the other is a matter of politics; it indicates additional beliefs about human nature that are not addressed.

65. *See* G. BENSTON, CONGLOMERATE MERGERS (1980); R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 228-31 (1980); DeAngelo, DeAngelo & Rice, Going Private: Minority Freezeouts and Stockholder Wealth 27-28, 36 (1982) (unpublished manuscript); Easterbrook & Fischel, *The Proper role, supra* note 59, at 1187-90; Weston, *Industrial Concentration, Mergers and Growth*, in II MERGERS AND ECONOMIC EFFICIENCY (1980).

66. Large premiums may be due to legal rules, defensive tactics, and bidding competition. *See* Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1175. However, this explanation does not account for the substantial premiums paid in cash-out mergers in which defensive tactics and bidding competition do not exist, much less in cash-out mergers at a premium in those jurisdictions where legal rules are more relaxed than they were in Delaware. Indeed, except for bidding competition, there is no apparent connection between the cause and the effect. While defensive tactics may defeat an offer, how offering more can counter moves designed to operate against the offeror in a nonmonetary way remains unclear.

See Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1188-90. They note that after a failed tender offer, the price of the target often rises. They suggest that this may be due to the market's perception that the bid is only the first round of a longer auction or that management has been roused to action. One could just as well argue that such a price increase is due to the public shareholders' being reassured, by another company's interest, that the business of the target is in fact quite promising. The kind of information conveyed cannot be determined unless the questions in the minds of shareholders are known. These explanations for price rises after thwarted tender offers assume that the price set in an efficient market is the most accurate measurement of the value of a share of stock. But even if compensate that part of the shareholder population that opted to hold out for more.[67]

A fair assumption is that the controlling shareholders are among the nontenderers, otherwise they would have put their own substantial investments elsewhere. The controlling shareholders are presumably entitled to their views too,[68] but their ability to make them known is limited. Since the market often, if not always, undervalues the controlling shareholders' stock,[69] they may be threatened even if they are doing an optimum job. The mere fact that a tender offer succeeds in shifting control does not necessarily mean that the company was less well-managed in the first place.[70]

One commentator has suggested that if the incumbents are correct they

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to outguess the market for purposes of trading is impossible, there are good reasons to credit individual shareholders' opinions in the context of a tender offer. *See* R. Booth, The New Law of Freeze-Out Mergers (1984) (unpublished manuscript). Among the more salient reasons are (1) that market prices are by definition set by the least optimistic of current shareholders (those most ready to sell), and (2) the existence of a tender offer alters the way a rational shareholder values any individual stock, by converting the largely random process by which stocks are picked to compose a portfolio into the equivalent of a negotiation with the offeror company. The suggestion of Professors Easterbrook and Fischel that the defeat of a tender offer and a rise in the target stock's price thereafter may owe to the shareholders' viewing it as but the first step in a longer auction is certainly a possible explanation, but not the only one. Thus it does not follow that defensive tactics should be prohibited categorically. *See infra* note 70. These views are largely supported by Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); *see* R. Booth, *supra passim.*

67. Note, however, that if upon receiving the tenders of 50% + 1 of the shares, the bidder could force all the rest of the shareholders to sell at the same price, half the shareholders would be undercompensated and half would be overcompensated. The bidder, however, would have paid a total price that approximated the total of shareholder valuations. One could fault the distribution, although it is pro rata, but one could hardly fault the successful bidder as having obtained any kind of windfall. Convincing a court that the bidder should be required to pay more to those undercompensated would be difficult, because the bidder has already paid out full value. *See* Singer v. Magnavox Co., 380 A.2d 969, 971 (Del. 1977). A tender offeror will often, however, threaten to force the sale of the remaining shares at a lower price. *See* Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485, 487 (1983). For a critical analysis of two-tier pricing, see Brudney & Chirelstein, *supra* note 15, at 336, 340; Brudney & Chirelstein, *supra* note 14, at 1359-65.

68. *See* Singer v. Magnavox Co., 380 A.2d 969, 976 (Del. 1977); Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977). Although the idea that in an efficient market a shareholder should tender for any premium is at first compelling, it does suggest that management resistance is irrational. Managers who are substantial shareholders should also be induced to tender. Managers who are not important shareholders should, in the interest of their professional reputations, negotiate a sale.

69. This follows from the phenomenon that the market price is set by the most willing seller, as well as the fact that insiders could quite legally sell out at a premium if they so desired. *See supra* notes 15, 64 & 66.

70. Other things being equal, the opinion of the shareholders as to the value of the target company under current and proposed management is, and should be, an important factor in the success or failure of a tender offer. Management may legitimately disagree with the shareholders' assessment, however, especially since the market serves as no guide once an offer has been made and the factors to be assessed in deciding whether the price is adequate (for example, risk) are so subjective. Circumstances in which the shareholders' collective opinion is distorted may exist, however. An example is the period after a long depression in the stock market. Indeed, it seems that tender offers are far more common in depressed markets, although no reason dictates believing that discrepancies in management's ability or innovative ideas are more common in bearish times than in bullish times.

should be able to find a white knight,[71] but that statement assumes a shift in control will occur simply because someone decided to make a tender offer. Unless one believes that most corporations are inefficiently managed and that shifts in control are somehow to be favored over the status quo, corporate managers clearly should be as free to defend their incumbency in take-over battles as they are in proxy fights.[72] It might be suggested that if the incumbents believe that they are the best managers, they should be willing to offer more for the company's stock than the bidder. Aside from the practical question of where the money, a scarce commodity, is to be obtained, this solution effectively forces the corporation to reduce its capital and in effect to declare a dividend, at the prompting of an outsider. That might often defeat the very investment plans on which the incumbents base their optimistic valuation. Managers need to be able to use their office to keep themselves in office if a fair fight is to be had. The business purpose doctrine is recognition of that need.[73]

II. The Business Purpose Doctrine and Exercise of Control

The preceding cases have all involved the use of control to retain control, but other cases have occurred in which the business purpose doctrine has been applied. These cases involve the use of control to effect transactions beneficial to a controlling shareholder.

Without doubt the most notable application of the business purpose doctrine was in *Singer v. Magnavox Co.*,[74] a case that has been overruled on that very point. *Singer* arose from a cash-out merger following a tender offer. The parent corporation had acquired eighty-four percent of Magnavox's stock in the tender offer and soon afterwards effected a cash-out merger at the same price as the tender offer price. The remaining

71. *Structural Approach, supra* note 62, at 868.

72. For example, if a company really were inefficiently managed, management could profit by looking for a purchaser of the assets and taking credit for the move. If they could so profit, presumably they would. This dilemma is unavoidable in economic analysis: transactions are explained as movements of assets to their most productive uses. The difficulty is that after the free market has operated for a while, everything would already be optimally allocated and transactions would stop. The scenario is somewhat fanciful, but it raises the disturbing question of what is the status of the market in question as analysis commences. Has the market already reached equilibrium or has it somehow been kept from it or are the apparent obstructions to trade relatively minor details that arise for other reasons once equilibrium has been achieved? *See supra* note 13.

73. Professors Easterbrook and Fischel argue that the business *judgment* rule arises from a manager's duty of care, rather than his duty of loyalty and has been misapplied in the context of tender offer defenses when conflicts of interest are naturally present. Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1194-1204. Their characterization of the business judgment rule in its garden variety is accurate, but beside the point. Properly speaking, the business *purpose* rule is what the courts have applied, because it fits circumstances in which conflicts of interest are present. *See* Arsht, *supra* note 1, at 115-18, 127-30. Professors Easterbrook and Fischel do argue consistently that conflicts of interest should be proscribed and that managers, therefore, should remain passive in the face of tender offers. *See* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982). The difficulty with their position is that the courts do not regard conflicts of interest as per se improper for corporate managers. *See supra* notes 42-54 and accompanying text.

74. 380 A.2d 969 (Del. 1977).

shareholders of Magnavox sued. The court noted that even though the merger satisfied the letter of the law, fiduciary duty imposed a higher standard and that a merger motivated solely by the parent's desire to eliminate minority shareholders would therefore be illegal.[75] The court held that minority shareholders have a right to the form of their investment and that they should not be forced to give up their common stock unless the majority could show a good reason for the transaction.[76] Unless the merger had a valid business purpose, the court held that it could be enjoined,[77] and that even if a valid business purpose was shown, the merger would be reviewed for its "entire fairness."[78]

The notion of entire fairness was apparently borne of the fact that review of price alone was insufficient. In most cases, a shareholder who is forced to surrender his shares in connection with a merger that he has opposed is entitled by statute to have his shares appraised by a court and to be paid in cash.[79] Prior to *Singer* the courts of Delaware had held that if a shareholder had a right of appraisal he could not maintain a lawsuit for other sorts of relief (for example, rescission) unless he proved fraud; appraisal ought to suffice if the only issue was fairness of price.[80] Implicit in the reasoning of *Singer*, however, was the premise that appraisal was an inadequate remedy in the context of a parent-subsidiary merger. Scrutiny for entire fairness was an effort to develop the sort of review that should accompany business purpose cases: judicial review that somehow takes into account nonmonetary issues.

In subsequent cases it became clearer that the *Singer* rule was to be interpreted in a way that differed from most prior business purpose cases. First, in *Tanzer v. International General Industries, Inc.*,[81] the Delaware Supreme Court confirmed that even though a valid business purpose existed for a freeze-out merger, the minority was entitled to a fairness hearing. In *Roland International Industries, Inc. v. Najjar*,[82] a case involving a short-form merger,[83] the Delaware court held in effect that a business purpose for the merger must exist, even though the short-form merger statute

75. *Id.* at 978.

76. *Id.* at 977.

77. *Id.* at 980.

78. *Id.* at 977.

79. DEL. CODE ANN. tit. 8, § 262 (1983).

80. *See* Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78, 80 (1962); David J. Green & Co. v. Schenley Industries, Inc., 281 A.2d 30, 33 (Del. Ch. 1971); *see generally* Vorenberg, *Exclusiveness of the Dissenting Shareholders' Appraisal Right*, 77 HARV. L. REV. 1189 (1964) (appraisal remedy should not provide license to freeze-out minority shareholder); Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 653-55 (1981) (strict procedures and exclusivity of appraisal remedy allow possible exploitation of minority shareholders); *infra* note 173.

81. 379 A.2d 1121, 1125 (Del. 1977). *Tanzer* also held that the business purpose of the parent or majority shareholder would suffice.

82. 407 A.2d 1032 (Del. 1979).

83. The short-form merger procedure allows a parent corporation that owns 90% or more of a subsidiary to absorb it without a vote of the directors or shareholders of the subsidiary. *See* DEL. CODE ANN. tit. 8, § 253 (1983).

clearly was intended to allow elimination of minority interests.[84] The court unequivocally held that the burden rested on the majority to prove a valid business purpose[85] and that actions seeking money damages only would be recognized even though in theory this was a purely equitable cause of action based wholly on nonmonetary injury to minority shareholders.[86] Finally, in *Harman v. Masoneilan International, Inc.*,[87] the court applied the business purpose test to a stock-for-stock parent-subsidiary merger, even though the test had been devised to handle the perceived inequity in cash mergers.

These refinements amount to a radically different concept of business purpose. Under the traditional business purpose exception, plaintiffs had been required to show that the only possible motivation for the transaction was nonbusiness.[88] Under the *Singer* line of cases the parent was in effect required to persuade the court of the need for the transaction.[89] In other words, the majority shareholder was required to show a compelling business purpose rather than a discretionary one. Even when such a showing was made, however, the plaintiff was entitled to a fairness hearing. The court had established a per se rule for parent-subsidiary mergers and indeed possibly all mergers.[90] The rule of *Singer* was not the traditional business purpose rule, but something altogether different. No doubt the reason for this departure from the traditional winner-take-all resolution of business purpose cases lay in the unstated assumption that there is one correct price for a share of stock and that if the majority can show that the price can be achieved only if the majority rids itself of the minority, the minority is all the more entitled to its share of the gain.

The business purpose test as defined by *Singer* and its progeny was declared no longer to be of any "force or effect" in *Weinberger v. UOP, Inc.*[91] In order to cope with the value lost to the minority shareholder who is forced to sell, the court modified its interpretation of the appraisal remedy, presumably as it applies to all mergers,[92] and declared it once again to exclude an action at equity except in cases of self-dealing, fraud, and the

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84. 407 A.2d at 1037. *Roland* overruled *Stauffer v. Standard Brands, Inc.*, which had held precisely the opposite. 187 A.2d at 80.

85. 407 A.2d at 1037; Singer v. Magnavox Co., 380 A.2d 976, 978-79 (Del. 1977).

86. 407 A.2d at 1035, 1037; *see* Harman v. Masoneilan Int'l, Inc., 442 A.2d 487, 494 (Del. 1981); *supra* note 57 and accompanying text.

87. 442 A.2d 487, 494 (Del. 1981).

88. *See* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548, 554 (Sup. Ct. 1964).

89. One is tempted to assume that something either does or does not have a business purpose, but requiring a plaintiff to prove that no purpose exists, or that the sole purpose is nonbusiness, and requiring a defendant to demonstrate some positive purpose are very different. *See* Weinberger v. UOP, Inc., 426 A.2d 1333, 1350 (Del. Ch. 1981), *rev'd*, 457 A.2d 701 (Del. 1983).

90. Few, if any, mergers are accomplished in one step, and *Singer* applied to all two-step mergers. *See* Brudney & Chirelstein, *supra* note 14, at 1359-65.

91. 457 A.2d 701, 715 (Del. 1983).

92. The court's opinion does not indicate that the revised appraisal remedy is to be limited to particular kinds of mergers. Since the revisions are based largely on statutory language, any principled limitation was probably not intended.

like.[93] The court in effect imposed a negotiating model on future freeze-outs, requiring a vote or other device to provide at least some assurance that the minority would have sold its stock voluntarily and that a price comparable to an arm's length price would be set.

On its face a cash-out merger presents a fact pattern distinctly similar to that seen in contests for control, because in both cases only one winner will emerge. If the majority can demonstrate that the minority is somehow the cause of positive damage to the majority's shareholder interest, the parallel is apparent, and if one believes that all shares of stock are of equal value, the minority's entitlement to its proportionate share of the gain sought by the majority is equally apparent. An important difference arises, however, because the minority shareholder, whose interest is wholly monetary, can be made whole.[94]

Whether the *Weinberger* decision will be read to overrule only the business purpose test as enunciated in *Singer*, or will be viewed to have eliminated the business purpose exception in all of its applications is unclear. Any court tempted to resort to the doctrine will undoubtedly hesitate now and, at the very least, will apply a heightened level of analysis.

A second branch of business purpose cases dealing with a controlling shareholder's use of his position descends from *Sinclair Oil Corp. v. Levien*.[95] Sinclair owned ninety-seven percent of another oil producing company and controlled its board of directors. Over the course of seven years the subsidiary had paid dividends fifty-four percent in excess of its earnings. A shareholder of the subsidiary claimed that the dividends were paid because of Sinclair's need for cash and that the subsidiary would have been able to pursue growth opportunities if it had retained the money.

The court found that the dividends were paid within the letter of the law and that, in the absence of self-dealing, the plaintiff must show that they could not be grounded on any reasonable business objective before the court would interfere.[96] The court noted that self-dealing, which would allow review for intrinsic fairness, could not be shown, since the dividends had been paid equally to all shareholders.[97] The court stated that in order to prevail the plaintiff must show that the payments were improperly motivated and amounted to waste.[98] While this requirement at first sounds like

93. 457 A.2d at 714; *see supra* note 80 and accompanying text; Cole v. National Cash Credit Ass'n, 18 Del. Ch. 47, 156 A. 183, 187 (1931).

94. *See infra* notes 150-67 and accompanying text.

95. 280 A.2d 717 (Del. 1971).

96. *Id.* at 720-22.

97. *Id.* at 721-22.

98. *Id.* at 722. The court followed a confusing path in reaching this conclusion. *See* Arsht, *supra* note 1, at 105-07. First, it dismissed the defendant's argument that the business judgment rule should be applied in the absence of "gross and palpable overreaching." 280 A.2d at 722. Then, in an ambiguous passage it stated that a manager's business judgment will be respected unless the decision in question cannot be attributed to a rational business purpose. The court further stated that the test of intrinsic fairness, with its shift in burden of proof, will be applied if "the parent has received a benefit *to the exclusion and at the expense of the subsidiary*." *Id.* at 720 (emphasis added). After rejecting the test of abuse of discretion, the court held that no self-dealing arises when equal treatment is present, and

an alternative rule, it is in fact substantially equivalent to the business purpose rule, but its application to dividends seems quite odd.[99] One must ask what possible business purpose the declaration of a dividend could serve and how a corporation's paying out of substantial sums of cash could further its business. The answer seems obvious. Dividends are part of the bargain made between shareholders and the corporation.[100] The court apparently believes that if the dividends bear no reasonable relationship to that bargain, then a remedy may be available. The construction of the bargain, however, is left to controlling shareholders. Nevertheless, as was noted by the courts in connection with freeze-outs, the controlling shareholder's interest is as legitimate as that of anyone else.[101] Thus in this context business purpose may comprehend both corporate purpose and shareholder purpose, as it does in the retention of control cases.[102]

III. The Limits of the Rule of Equal Treatment

These issues invariably prompt commentators to recall the general rule that shareholders are entitled to equal treatment.[103] Perhaps the strongest judicial reaction to the notion that controlling shareholders are privileged to favor themselves is found in *Donahue v. Rodd Electrotype Co. of New England, Inc.*[104] In *Donahue* Mr. Rodd's family owned a controlling eighty percent interest in the company, and the Donahue family owned a twenty percent interest, acquired at the suggestion of Mr. Rodd when the company was purchased. Mr. Rodd desired to retire and arranged to transfer most of his shares to various relatives. An arrangement was made with the corporation to repurchase the remaining shares, representing an eighteen percent interest, for $36,000. Mrs. Donahue sued on the theory that the repurchase of Mr. Rodd's shares amounted to a preferential distribution in his favor. The court concluded that the corporation in question was a close corporation and that shareholders in a close corporation owe each other a duty similar to that owed by one partner to another.[105] As a result of this duty, the court concluded, a requirement of strict equal treatment among shareholders arises.[106] In a footnote the court significantly limited

recharacterized plaintiff's burden first as one to show improper motive and waste and then as one to show fraud or overreaching. *Id.* at 722. While the connotations of these formulations differ, they all describe a much heavier plaintiff's burden than merely showing self-dealing. However, both fraud and overreaching have a conclusory flavor that leaves little of substance but "motive," "purpose," and "waste" together with the notion of benefits taken to the exclusion and at the expense of the subsidiary. *See supra* note 28.

99. *See supra* text accompanying note 57.

100. *See* Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1180-82, 1191-92.

101. *See* Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1123 (Del. 1977); *supra* note 68 and accompanying text. The trial court in *Weinberger* recognized that one of the values to a parent of increasing its stock ownership to 100% was the ability to extract cash from a business by declaring dividends solely according to the parent's needs. *Weinberger*, 426 A.2d at 1333.

102. *See supra* text accompanying notes 39-73.

103. *See supra* notes 14, 15 & 20.

104. 367 Mass. 578, 328 N.E.2d 505 (1974).

105. 328 N.E.2d at 511-13.

106. *Id.* at 518-19.

this rule to transactions not involving third parties or outsiders.[107] The apparent reason for this limitation is that the court did not want to foreclose sales of controlling interests to outsiders, which is one of the few sources of liquidity in a close corporation. Presumably many sales of small corporations would be disabled by the need for the purchaser to buy 100% of the shares or, if the purchase money were required to be distributed pro rata, to risk the continued participation of a former controlling shareholder as a minority shareholder.[108]

Without more facts one can easily see how the court reached its decision. Moreover, the controlling Rodd shareholders had two years before offered to buy out Donahue interests at a price considerably less than the price paid Mr. Rodd in the challenged transaction. Thus evidence existed to suggest that the repurchase of Mr. Rodd's shares was improperly motivated. Nevertheless, the case is troublesome because many desirable transactions would be precluded by the rule of strict equal treatment. For instance, if Mr. Rodd had been unable to retire but for the payment, and the corporation had had insufficient cash to offer pro rata payments to other shareholders, the rule would seem to lock everyone into the business, rather than allowing anyone out.[109] Moreover, the distinction between inside and outside transactions breaks down quite readily. Suppose that instead of causing the corporation to purchase his shares, Mr. Rodd managed to find an outside purchaser. His shares would be salable only because they represented a controlling interest, and the minority might indeed be worse off with a stranger in control than it would be if Mr. Rodd had been allowed to accomplish the original transaction. It appears doubtful, therefore, that the court could avoid eventually extending the rule of *Donahue* to transactions with outsiders.

The alternative to the *Donahue* rule of strict equal treatment is the business purpose test. The factual situations in which the rule of equal treatment fails are those in which an opportunity is indivisible, and the business purpose test provides the flexibility to deal with these situations.[110] If in fact the opportunity in question is not indivisible, the busi-

107. *Id.* at 515 n.18.

108. *See* Brudney & Chirelstein, *supra* note 15, at 325-26; Brudney & Chirelstein, *supra* note 14, at 1356-57 n.9. Professors Brudney and Chirelstein note that in close corporations, such as in *Donahue*, freeze-outs generally arise as a result of continuing controversies approaching deadlock, thus generating very different issues from those arising in public corporations. *See infra* text accompanying notes 145-49. They also note that in the context of parent-subsidiary mergers, the benefits are hardly ever indivisible. *See supra* text accompanying note 94; *infra* notes 184-89 and accompanying text. Close corporations and public corporations have vital differences. That fact does not, however, affect the basic thesis here, nor does it invalidate all comparisons of close corporations and public corporations. Indeed, one would presume some similarities between two kinds of organizations going by the same name and, in some states, organized under precisely the same statutes.

109. *See Donahue*, 328 N.E.2d at 515; Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987, 1003 (1974); Brudney, *supra* note 14, at 1053; Brudney & Chirelstein, *supra* note 14, at 1369; *cf.* Brudney & Chirelstein, *supra* note 15, at 306 (asserting that parent's control over market price of subsidiary shares renders right of appraisal ineffective when a conflict of interest, rather than managerial incompetence, is involved).

110. *See supra* note 108.

ness purpose test leads to the conclusion that an alternative more injurious to the minority was chosen for no good reason, indicating that equitable relief is appropriate.[111]

A mere two years after *Donahue* the Massachusetts court, not surprisingly, reconsidered the rule of strict equal treatment. In *Wilkes v. Springside Nursing Home, Inc.*,[112] the court expressed its concern that indiscriminate application of the rule of strict equal treatment would jeopardize legitimate corporate action, noting that controlling shareholders have at least some privilege of selfish enjoyment of their property.[113] In *Wilkes* the owner of a substantial interest in the nursing home was unseated from the board of directors and relieved of his management responsibilities apparently because of a personal conflict with one of the other managing shareholders. As a result of losing his job, Wilkes was cut out of his primary source of financial participation in the corporation. The court held that Wilkes was indeed entitled to his position, salary, and right to participate in management, but declined to base that holding on *Donahue*.[114] The court instead devised a new rule requiring the controlling shareholders to show a legitimate business objective for the challenged transaction and giving the minority shareholder an opportunity to show that the same objective could be achieved by less offensive means.[115]

The mutually exclusive relationship between the business purpose test and the rule of equal treatment thus becomes quite clear, albeit in the context of a close corporation. The same conflict is implicit in the Delaware freeze-out cases, wherein minority shareholders sought equality in being allowed to retain their investments.[116] In contested takeovers the issue arises in terms of the power of managers to retain control and to deprive the minority of considerable gains.[117] The conflict is less evident in *Sinclair*, but is still present because the noninvestment policy clearly favored the controlling majority.[118] Use of the business purpose standard signals recognition of a certain level of privilege to insiders when an indivisible benefit is available.[119] Business purpose, therefore, should be the focus in any sale of control case, but the courts have rarely reviewed such transactions.[120] This lack of review is partly because a sale of control by a controlling shareholder is obviously a matter of legitimate shareholder interest

111. *See supra* notes 57 & 98 and accompanying text; *infra* note 115 and accompanying text.

112. 370 Mass. 842, 353 N.E.2d 657 (1976).

113. 353 N.E.2d at 663; *cf.* Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1123 (Del. 1977) (parent corporation does not violate its duties as majority stockholder in subsidiary by causing cash-out merger when necessary to accomplish parent's financing objectives).

114. 353 N.E.2d at 663.

115. *Id.*; *accord* Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

116. *See supra* notes 74-94 and accompanying text.

117. *See supra* notes 22-73 and accompanying text.

118. *See supra* notes 95-102 and accompanying text.

119. *See* Brudney & Chirelstein, *supra* note 15, at 325-26; Brudney & Chirelstein, *supra* note 14, at 1356-57 n.9.

120. *See* W. CARY & M. EISENBERG, *supra* note 15, at 511-13.

and only tenuously connected to the conduct of business; the corporation's funds are not being used.[121] Likewise, the weakness of the business purpose test as applied in a cash-out merger becomes apparent. If one assumes that the minority shareholder's primary concern is making money, the only issue is whether he is being paid enough. The opportunity to be cashed out is in no sense indivisible and even if it were, the majority is not itself claiming it.[122]

Nevertheless, the question still remains as to what justifies the minimal burden of persuasion that is placed on controlling persons when the business purpose test is applied. Even in the realm of corporation law, it is difficult to argue against equality of treatment among shareholders as somehow an ultimate moral value.[123] Equality before the law is, after all, the very foundation of the political system and is the source of the unique force of a government of laws.[124] Not only does equality guarantee fairness, but it also restrains governmental action; unless a rule can be universalized, it will be held invalid.[125] The principle is so simple that it seems intuitive that it must apply to corporations, at least in the absence of a better one.[126] One would think that at the very least a noncontrolling shareholder should have the opportunity to prove that the injury to him is greater than the benefit to the insider. Instead, at the most the courts will sometimes compare the insider's personal and business motivations.[127] What possible justification is there for this institutionalized inequality?

The fact is that equal treatment of shareholders is a valuable concept, but not a basic goal of corporation law to be applied presumptively in the absence of any better principle. Moreover, the notion of business purpose is not amenable to use as a justification for unequal treatment. Business purpose is recognizable only in what it is not. Many good reasons support requiring the party challenging a transaction to show that no valid business purpose exists, but to require the party defending a transaction either to show that he had compelling reasons, or that the benefits to him somehow exceeded in weight the detriment to the outside shareholders, is inappropriate.

121. *See* Brudney, *supra* note 14, at 1053-54. In theory, the source of the money used is irrelevant. *See* Tanzer v. International Gen. Indus., Inc., 402 A.2d 382, 393 (Del. Ch. 1979). Money is a scarce commodity, however, and the fact that an acquiring shareholder has his own funds and does not need to borrow them should perhaps count for something.

122. *See supra* text accompanying note 94.

123. *See infra* note 161 and accompanying text.

124. *See, e.g.*, U.S. CONST. amends. V & XIV.

125. *See, e.g.*, A. BICKEL, THE LEAST DANGEROUS BRANCH 49-65 (1962); Wechsler, *Toward Neutral Principles of Constitutional Law*, 73 HARV. L. REV. 1, 19-20 (1959).

126. One could fairly say that Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), so held. Despite the rule, however, mergers were seldom enjoined. One of the few examples is Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978). A damages formula was devised instead to punish illegitimate mergers. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497 (1981); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

127. For example, trial court recognized in *Weinberger v. UOP, Inc.*, 426 A.2d at 1350, that a business purpose need not be compelling to be valid. *See supra* note 89 and accompanying text.

In order to understand this logic, one must resort to the very foundations of corporation law and take a serious look at the rationale for the corporation in light of competing forms of organization such as partnership. Among the features that distinguish corporations from other forms of business organization is the free transferability of shares.[128] From an investor's point of view this is a virtue in itself. As long as there is a market, a share of stock can be turned into cash almost on a moment's notice. Indeed, a stock's value increases as it becomes more liquid. From the corporation's point of view, it would be extremely difficult to raise capital unless investors could be assured of the ability to sell.[129]

A general rule of equal treatment is necessary to ensure liquidity. Unless participations in corporations are essentially standardized and treatment is therefore largely equal, investment in new issues by any significant number of people would be precluded by the cost of learning the precise terms of the deal.[130] Without a general rule of equal treatment, it would be impossible to raise equity capital other than face to face, and the size of ventures that may be undertaken would be severely limited.[131] Standardization of share treatment, therefore, not surprisingly is one of the areas more strictly self-regulated than regulated by law. The states allow unlimited classes of stock. So in theory a corporation could issue separate classes with differing rights to each shareholder.[132] The stock exchanges, however, effectively limit the number of classes of common stock that a listed company may issue and refuse to list any equity issue of a company that issues nonvoting common stock.[133]

This rationale for equal treatment must be kept in mind. To the extent

128. "Free transferability" means the absence of impediments to transfer. Of course, a market for the firm's stock must be available if free transferability is to be much of an advantage. *See* W. CARY & M. EISENBERG, *supra* note 15, at 20-23, 281-83; W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 132-39 (1980).

129. *See* SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, pt. 1, 9-19 (1963).

130. *Cf.* Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1171-73, 1181-82 (discussing areas of corporate law recognizing shareholders' inability to monitor management performance); R. WINTER, GOVERNMENT AND THE CORPORATION 13 (1978) (discussing drawbacks of proposals aimed at increasing power of shareholders over corporate destiny).

131. Undoubtedly the best known discussion of this phenomenon is the dissenting opinion of Justice Brandeis in Liggett & Co. v. Lee, 288 U.S. 517, 578-80 (1933). The Court had just struck down as unconstitutional a Louisiana tax designed to limit the proliferation of chain stores. Justice Brandeis bemoaned the demise of limitations on total capital, the scope of business, and shareholders' powers to control managers, and he characterized corporations as a threat to democracy in essence because of their monopolization of opportunities. He did not deny that considerable sums of capital might be required to undertake profitable projects, but rather suggested that some form of cooperative effort or industrial democracy would be more consistent with the political system and the fourteenth amendment in particular. *See infra* notes 150-67 and accompanying text.

132. *See, e.g.*, DEL. CODE ANN. tit. 8, § 151 (1983). Illinois, whose constitution prohibits nonvoting stock, is the prime counterexample, and even that restriction has been severely diluted. *See* Stroh v. Blackhawk Holding Corp., 48 Ill. 2d 471, 272 N.E.2d 1, 5 (1971).

133. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL §§ 305, 313 (1983). Undoubtedly similar concerns motivate the English in their City Code to discourage tender offers for less than all outstanding shares and the French Company of Brokers to require that any premium for control be shared with minority shareholders. A. CONARD, CORPORATIONS IN PERSPECTIVE 209-12 (1976).

that strict application of equal treatment impedes the substantive corporate goal of maximizing return on investment, equal treatment must give way. Shareholders value equal treatment only to the extent that it adds value to their stock.[134] Limiting the scope of equal treatment does not necessarily detract from its liquidity-giving properties. Stockholders can adapt to certain acceptable forms of unequal treatment that will become standardized and well known in the market. Moreover, to the extent that unequal treatment is objectionable, a corporation with more than a few shareholders has little chance to escape sanctions, formal or informal.[135]

On reflection it becomes clear that equality of treatment has never been an especially powerful moral force in corporation law. Typically dividends, liquidation shares, and voting rights are cited as elementary examples of the centrality of the equality concept.[136] Not even the dividend example is without exception, however. In lieu of dividends many companies repurchase shares on the open market, effecting a reverse dilution[137] of shares not sold back. The practice is widely approved, but clearly not pro rata. The unsuspecting seller gets less than the hold-out and his shares are by definition purchased for less than the insiders think they are worth. This is in substance a redistribution of wealth within the corporation. It can be likened to insider trading undertaken for the benefit of all remaining shareholders.[138]

Along with the foregoing examples of required equal treatment can be included the Williams Act, which governs tender offers.[139] The Act requires that within any one tender offer all tendering shareholders receive the same price per share and have equal percentages of their tendered

134. Easterbrook & Fischel, *supra* note 15, at 703-04. That liquidity enhances the value of stock is, of course, well known. Indeed, destruction of the market for a particular security has been held actionable. Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); United Funds v. Carter Prods., Inc., [1961-1964] FED. SEC. L. REP. (CCH) ¶ 91,288 (Balt. Cir. Ct. 1963); *see* Note, *Going Private*, 84 YALE L.J. 903, 916-19 (1975).

135. *See* Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 402 (1977); Bethlehem Steel Co. v. Turner Constr. Co., 2 N.Y.2d 456, 141 N.E.2d 590, 161 N.Y.S.2d 90 (1957) (increase of price by steel erector did not violate contract with general contractor since increase was effectively "controlled" by steel company's dealings with numerous other customers). Of course, this effect does not hold for close corporations, which may account in part for their distinctive treatment. *See generally* Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957); Donahue v. Rodd Electrotype Co. of New England, Inc., 367 Mass. 578, 328 N.E.2d 505 (1974). Nor does it hold in those cases in which the transaction itself will eliminate those who object. *See* Brudney & Chirelstein, *supra* note 14, at 1368; Note, *supra* note 134, at 906-09.

136. *See* Brudney, *supra* note 14, at 1027. Liquidation shares and voting rights are weak examples at best; these rights would rarely be distributed unequally at least in any formal way. *But see* Chew v. Inverness Management Corp., 352 A.2d 426, 427-28 (Del. Ch. 1976); Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 CORNELL L. REV. 1, 44 (1970); Chayes, *Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532, 1543 (1960).

137. An unfortunate phrase, but probably clearer than the straightforward "concentration of equity interest."

138. *See* DEL. CODE ANN. tit. 8, § 160 (1983); Brudney, *supra* note 14, at 1044-50.

139. Securities Exchange Act of 1934, § 14(d)(6), (7), 15 U.S.C. § 78n(6), (7) (1982).

shares purchased.[140] Rather than being an example of equal treatment, however, the Williams Act is better regarded as an expression of the widespread belief that equal treatment is a basic value in corporation law.[141] In any event, neither the Williams Act nor decisional law requires equal treatment of nontendering shareholders,[142] and the Williams Act itself does not prohibit price discrimination in separate tender offers.[143] Far from equal treatment being a basic value in corporation law, the suggestion is strong that without some additional justification, unequal treatment should never be regarded as a sufficient predicate for liability.

Still, the fact that a rule of strict equality may not be necessary only evens the score. The question remains whether any good reason justifies unequal treatment. In each of the prototypical cases, the reason for unequal treatment was the fact that only one solution was possible. Only one management team may be in control, and only one dividend policy may be pursued at a time.[144] Unless one is willing to entertain the possibility that no one prevail when such matters as these are seriously disputed, some device must be available to force a conclusion.

Corporation law embodies a systematic bias in favor of reaching decisions. Failure to decide is a recognized exception to the business judgment rule.[145] This contrasts sharply with partnerships in which deadlock readily leads to dissolution.[146] Corporations, on the other hand, are almost impossible to dissolve for mere impasse,[147] which encourages reaching a decision even when those in control might otherwise be reluctant to decide. Undoubtedly this bias for action rather than inaction is an important reason that so much attention is paid in the codes and by the courts to formalities of meetings. To encourage action the law virtually forces face-to-face confrontation among directors.[148] Thus, the tools of forcing a solution are naturally in the hands of those who control the corporation. To insist that

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140. *Id.*

141. *See, e.g.*, Securities Exchange Act Release No. 16,385 (Nov. 29, 1979). If a bidder were allowed to raise the bid during the course of a tender offer without being required to pay the new price to those who had already tendered, much of the rationale for proration would be eliminated. Shareholders would not be encouraged to tender at less than a price they believe to be adequate, knowing that they will receive any increased benefit if enough of the others hold out for more.

142. *See* Brudney & Chirelstein, *supra* note 4, at 336-40; Brudney & Chirelstein, *supra* note 20, at 1361-62.

143. *See* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 35 (1977).

144. Freeze-outs, though no longer governed by the business purpose rule, fell in the latter category. *See supra* text accompanying note 94.

145. Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 803 (Mass. App. Ct. 1981); Arsht, *supra* note 1, at 112-14.

146. *See, e.g.*, Ferrick v. Barry, 320 Mass. 217, 68 N.E.2d 690, 694-95 (1946); UNIF. PARTNERSHIP ACT §§ 31, 32 (1981).

147. *See, e.g.*, *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563, 564 (1954); Chayes, *supra* note 136, at 1545; Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 3 (1977).

148. *See, e.g.*, Hurley v. Ornsteen, 311 Mass. 477, 42 N.E.2d 273, 275-76 (1942); Stone v. American Lacquer Solvents Co., 463 Pa. 417, 345 A.2d 174, 177 (1975); MODEL BUSINESS CORP. ACT §§ 43, 44 (1979).

they be elsewhere would amount to a presumption that management is almost always in the wrong.[149]

Moreover, positive reasons do exist as to why incumbents should have an edge. A corporation is a three-way bargain between a government, shareholders, and management.[150] The bargain between the shareholders and management is straightforward: shareholders would not put their money into the corporation unless they expected a return. Moreover, they must expect a greater return than is available to them in other less risky investments.[151] A corporation thus has a duty to invest profitably at a return in excess of the cost of the funds being used. If investors demand payments of ten percent for their money, the corporation is supposed to find investments returning something more than ten percent.[152] A corporation can not justify retaining equity when a shareholder can put it to better use.[153]

The necessity of the business purpose doctrine arises directly from management's role in this bargain. Finding and managing investments that return more than prevailing rates of interest involves a decision to devote capital for varied reasons. Often, management uses little more than hunches that hardly ever can be justified in the sense that most people, provided with all the facts, would agree that the investment is the one that should be made.[154] To strike an analogy with standards of judicial review, the strictest test one could apply would be to allow reversal of a manager's decision when unsupported by the evidence, which is the equivalent of the irrationality exception to the business judgment rule.[155] The fact that a business decision may be against the weight of the evidence is not enough

149. Certainly this presumption has its followers, although they would likely stop short of advocating a scheme that overtly encouraged ouster of incumbents. After all, if power corrupts, it will get the insurgents too. *See* Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85 *passim* (1980); *supra* notes 64 & 72.

150. *See* Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819); R. WINTER, *supra* note 130.

151. *See* W. KLEIN, *supra* note 128, at 214-15, 254-56; J. WESTON & E. BRIGHAM, MANAGERIAL FINANCE ch. 17 (6th ed. 1978).

152. Since investment is almost invariably riskier than the status quo, most companies would be expected to establish a required return for new investments somewhat in excess of the rate actually demanded by shareholders before the new investment. J. WESTON & E. BRIGHAM, *supra* note 151, ch. 10. For an example of this method of investment decision-making in context, see Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

153. The shareholder's appraisal right, *see* DEL. CODE ANN. tit. 8, § 262 (1983), is sometimes said to have been intended to allow a shareholder to demand a return of his investment if the corporation significantly changes the nature of its business. *See* Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25, 29-30 (1958).

154. *See* J. WESTON & E. BRIGHAM, *supra* note 151, at 287; Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1195-97. Even if gathering all the available information about investment opportunities were possible, a consensus would probably not develop. A notable example came from the National Science Foundation, which recently disclosed that even it has been unable to devise a method by which to evaluate the relative merit of grant requests. *See generally* W. KOHLER, THE PLACE OF VALUE IN A WORLD OF FACTS (1938).

155. *See* Arsht, *supra* note 1, at 97-100, 121-27; Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1195-97; *cf.* Lind v. Schenley Indus., Inc., 278 F.2d 79, 84 (3d Cir. 1960) (jury verdict may only be reversed if no substantial evidence supports verdict).

to justify second-guessing the manager.[156]

If the concern is that deadlock may prevent the employment of assets altogether, it makes sense to grant incumbents the residual ability to force their own way when a real risk of impasse exists, even to the extent of favoring their personal interests over those of other shareholders.[157] In the first place, business activity is fundamentally different from government activity, because governments have traditionally engaged primarily in prohibition.[158] Such decisions are fairly easily subjected to vote, at least in theory, since the alternatives are only to prohibit or not to prohibit. Thus, simple majority rule is quite serviceable.[159] Making an investment decision, however, is quite another process. Innumerable alternatives are available, many of which will be eliminated as unprofitable, but no reason dictates that the remaining alternatives will only number two.[160] When the alternatives are greater in number, the results of a vote may well depend upon the order in which the alternatives are presented.

Few would seriously propose that major business decisions be made by shareholder vote, or a vote of any other constituency. Numerous proposals, however, have been made to replicate the diversity of constituent interests and to ensure that they are considered during board deliberations.[161] If the rationale for these proposals is simply to reproduce the result that would obtain if only a full shareholder vote could be held, they are subject to the same shortcomings. Any effort to divine the will of the majority,

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156. *See* Gottlieb v. Heyden Chem. Co., 91 A.2d 57, 58 (Del. 1952).

157. Whether an impasse has been reached in any particular case is a decision largely controlled by economic forces. Managers, whether or not they are themselves substantial shareholders, will not undertake any of the actions governed by the business purpose rule unless they believe it will be profitable or will avoid a decrease in profitability. *See supra* notes 64 & 68 and accompanying text.

158. Justice Douglas stated in the context of advocating self-regulation in the securities industry:

> Self-regulation . . . can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach.

Address by SEC Chairman William O. Douglas as quoted in Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROBS. 663, 678 (1964).

159. *See supra* text accompanying note 116; *cf.* Brudney & Chirelstein, *supra* note 14, at 1359-65 (majority rule in arm's length mergers is coercive but unobjectionable).

160. The process is particularly complex because of the impossibility of precise measurement of risk and, to a lesser extent, the cost of capital. *See supra* notes 151 & 152.

161. *See, e.g.*, ABA Section on Corporation, Banking and Business Law, *Report of Committee on Corporate Laws*, 33 BUS. LAW. 1591 (1978); Eisenberg, *supra* note 17; Ratner, *supra* note 136, at 44-56; Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419, 520-28 (1971); Manning, Book Review, 67 YALE L.J. 1477, 1490-91 (1958) (reviewing J. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958)). A similar argument is often made in favor of cumulative voting. *See also* Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970) (discussing generally concept of corporate democracy), *vacated as moot*, 404 U.S. 403 (1972).

whether by direct vote or otherwise, is inherently unreliable.[162]

An alternative rationale for the rule of equal treatment is that given enough time and information, a consensus would develop that takes all competing interests into account, but this reasoning is questionable. An investment decision is one that cannot be completely justified or explained.[163] A new product may not appear in advance to be particularly useful, but may become indispensable in use. The argument may always be made that until now consumers have managed to get along without it. Thus, justifying any further investment other than to replace aging assets may be impossible.[164] Undoubtedly a few consumer-voters will always perceive the utility of a proposed new product distinctly enough that they would, if asked, vote to devote scarce resources to its development; but the chances of any proposal's commanding a majority, or even out-polling the alternative of no action, are slim. Innovation depends upon individual action and vision.[165] Finally, a project conceived or even approved by some form of voting will likely be compromised to such an extent that no one will be motivated enough to manage it vigorously to fruition. No matter how much one may believe in the virtues of majority rule, the fact is that business is done by individuals who must be rewarded.[166]

If innovation is agreed in principle to be important, some means must be found to make productive assets available to the individuals who would manage innovative projects. If one fully expects that such "unjustifiable" ventures are to be undertaken, some mechanism must be provided by which the manager's discretion will not in the normal course be second-guessed or subject to prior restraint by the very forces that the mechanism is intended to overcome.[167] Corporations and the business judgment rule are, by and large, well devised to avoid the shortcomings of majority rule and to allow in an appropriately regulated environment the necessary room for individually initiated action.

162. *Cf.*, SEC, *Institutional Investor Study Report*, H.R. DOC. No. 64, 92d Cong., 1st Sess., Part 8, at 124-25 (1971) (existence of power of institutions such as banks to influence corporate decisions by vote does not demonstrate that it is in fact exercised). *But see* Werner, *supra* note 135, at 402.

163. *See supra* note 153.

164. *But see* J. GALBRAITH, THE NEW INDUSTRIAL STATE 203-07 (1967), in which the author argues that primarily through advertising producers can create demand or at least accurately predict it and hence that risk has largely been eliminated.

165. Note the parallel to the contradiction between status quo and dynamism. The proposition has often been made that private enterprise is in fact a better system than government ownership for the conduct of business. *See, e.g.*, M. FRIEDMAN, CAPITALISM & FREEDOM 4 (1962); J. SCHUMPETER, CAN CAPITALISM SURVIVE? 61-70 (1942).

166. *See* Easterbrook & Fischel, *The Proper Role*, *supra* note 59, at 1169-70. The assumption is often made that because corporations have a legal existence separate from any of the individuals that might be said to compose them, incentives are largely irrelevant and the fiduciary status of managers is paramount. A more reasonable assumption is that corporations have the character of human beings, rather than the opposite, and to adjust fiduciary duties appropriately.

167. This is not to say that managers should be relieved of any accountability. Indeed, the business judgment rule is not a particularly lax standard. *See* Arsht, *supra* note 1, *passim*. Moreover, internal bureaucratic pressure is probably a more powerful restraint than the law, and some reasons dictate its preference as a rule of law.

IV. A RESTATEMENT OF THE BUSINESS PURPOSE DOCTRINE

One can easily see how the business purpose test can look like a license to use a corporate office to promote self-interest. Under circumstances in which a manager's self-interest is inevitably apparent, the only circumstances in which the business purpose test is necessary, self-interest will almost always appear to be the more convincing explanation. Nonetheless, if the view here proposed is correct, the propriety of the relatively light burden on defendants is much clearer.

The essential justification for the business purpose rule, and for permitting a limited level of unequal treatment, is that the rule and the resulting inequity are necessary to rational investment. However, since use of the business purpose test signals that unequal treatment will be tolerated, one would expect that the behavior in question have some demonstrable connection to the investment process, at the very least that the challenged action may often be undertaken to further investment goals. Defensive tactics in tender offers are an obvious example. Less easy to see, however, is how all of this applies in the use of control cases. To understand that connection, one must look again to the nature of the bargain between managers and shareholders.

Simply stated, managers agree to make money for shareholders and shareholders agree to allow managers considerable freedom in doing so.[168] Thus, corporation law generally protects the manager's discretion to choose investments, but consistent with the bargain between the corporation and the shareholders, the law imposes a duty on the manager to pay dividends when no qualifying investment opportunities are apparent.[169] The famous case of *Dodge v. Ford Motor Co.*[170] illustrates this bargain very well. The company had been paying substantial dividends, both regular and special, for several years when Henry Ford, a fifty-eight percent

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168. *See* Easterbrook & Fischel, *The Proper Role, supra* note 59, at 1170-71. This relationship should not be regarded as purely fiduciary and equivalent to trusteeship, as commentators of all persuasions seem to do. The relationship is just as understandable as a contractual one, because both parties have something the other wants. Even if selfish motives in fact preponder, we should not necessarily bemoan advantage-taking by insiders and seek a way of distinguishing one from the other. After all, perpetuating oneself in office is necessary if one is to direct investments.

169. One can not always easily discern if dividends are being paid, since they may come in the form of cash or growth. The latter, of course, depends on the market, that is, the perceptions of shareholders. Thus dividends are paid if shareholders think that they are. *See generally* J. WESTON & E. BRIGHAM, *supra* note 151, ch. 20. When considering cash dividends, one cannot ignore the effect of taxes. Shareholders may, to a certain extent, prefer that a corporation retain cash even if it does not have investment opportunities, since the money will be taxed if paid out as dividends. However, these factors probably have been included in the "market's" calculation of the rate of return necessary for a particular investment. In addition, by selling the stock the shareholder can obtain the retained dividend and pay taxes at no more than 40% of the rate otherwise payable. While this would suggest a distinct preference for retention, it nonetheless depends on the expectation of subsequent purchasers that the money will eventually be paid out in cash by the corporation. *Id.*, ch. 17. Taxes do, therefore, affect shareholder preference for dividends, but it is fair to assume that such effects are built into what the market communicates to investors. *See infra* note 177.

170. 204 Mich. 459, 170 N.W. 668 (1919).

shareholder, declared that no more special dividends would be paid. He planned to use the money to expand the company's operations, while cutting the price of cars. The surplus of the corporation was $112 million at the time, of which $54 million was cash or near cash. Two minority shareholders sued to compel a dividend declaration of not less than three-fourths of the surplus. They introduced evidence that the expansion plans were not intended to make the company more profitable, and indeed would make it less profitable over the short term, but instead were motivated by the social concerns of Henry Ford.

In a decision still regarded as gospel on the subject, the Michigan Supreme court held that:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.[171]

The court, however, did not interfere with the proposed expansion. As the court further stated:

> We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In view of the fact that the selling price of products may be increased at any time, the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts.[172]

Thus, the court refused to interfere with the directors' discretion to invest as they saw fit, even though they were unable to show that their strategy would lead to greater profits.

The expansion plans, however, required only approximately $24 million, leaving liquid assets of nearly $30 million for which there were no particular plans. The directors argued that the business simply needed to have cash. While the court agreed that as a general proposition corporations do need cash, it affirmed the lower court's order that half of the "extra" cash be paid out as a dividend.[173] Simply stated, a corporation may not retain equity for no good purpose.[174]

The situation in *Sinclair*[175] was the converse of that in *Dodge*. In *Sinclair* the minority shareholder's complaint was that the corporation was paying dividends when it could have been investing. One has difficulty seeing how the business purpose test can apply at all in such a case, since the shareholders are getting what they bargained for. The shareholders can complain about the corporation's failure to retain earnings only if

171. 170 N.W. at 684.
172. *Id.*
173. *Id.* at 685; *see id.* at 677.
174. *See* Berwald v. Mission Dev. Co., 40 Del. Ch. 509, 185 A.2d 480, 483 (Sup. Ct. 1962); W. KLEIN, *supra* note 128, at 254-56.
175. *See supra* text accompanying note 95.

management somehow promised to pursue a growth strategy (and somehow promised not to change its mind). Even then something approaching active fraud would need to be shown, since management cannot fairly be thought to guarantee success.

The applicability of the business purpose test in *Sinclair* is easier to see if one considers the consequences of the alternative to presuming management's right to pay dividends. The plaintiff in *Sinclair* complained that the money was not invested, not that it was paid out. To hold managers liable for not investing necessarily requires them to make particular investments, since minority shareholders must identify particular opportunities in order to make out any case. The courts will not presume to find liability in such a case; that is merely the business judgment rule in its ordinary application.

The ultimate point of *Sinclair* is more significant. First, as a matter of sound policy the courts should not require that a business grow or refrain from shrinking. As long as they declare dividends, managers will not be required to invest at all, even though opportunities exist. To impose such a requirement would often be wasteful and would unduly limit the range of decisions available. As a practical matter, such a requirement could not be enforced anyway, since investment decisions are so subjective that the manager could always argue convincingly that the investment was not a good one. Corporations are designed to enable growth, not to enforce it, because ultimately growth cannot be forced.

In this context the business purpose test differs from the simple policy of noninterference that underlies the business judgment rule. Self-dealing and failure to manage could have been the court's focus in *Sinclair*. Those tests did not apply, however, because applying them would have added terms to the bargain between managers and shareholders that were not originally present and, more important, would have injected an element of affirmative mandate into an institution founded on the opposite. Under their bargain with shareholders, corporate managers are privileged not only to choose investments, but also to choose between the two basic and mutually exclusive policies of paying dividends by growth or by cash.[176]

One further point must be addressed. It has been argued that a corporation's dividend policy is irrelevant, since a shareholder can always sell a few shares when he wants some cash.[177] The Irrelevance Proposition, as this hypothesis has been dubbed, holds that the cash the corporation has retained will be reflected in the market price of the shares. The price may even be augmented if it is generally believed that the corporation has found or will find investment opportunities yielding more than those that comprise its current business. A shareholder, therefore, should not care

176. *See supra* note 169.

177. This view was first set forth by Miller and Modigliani in their now famous *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411 (1961). *See* V. BRUDNEY & M. CHIRELSTEIN, *supra* note 4, at 429-42; Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 701-02 (1981).

about a firm's dividend policy, or indeed should prefer that the corporation retain its cash.[178] By the same token, it would seem that the option of paying extravagant dividends should not be open to management.

In the first place, the Irrelevance Proposition seems to depend on a rule requiring either dividend payments or reinvestment in still more profitable projects. But for the rule, corporations would be free to accumulate cash for no particular purpose and shareholders would no longer be indifferent between dividends and retention. Second, as with the argument against allowing incumbents to oppose tender offers, the Irrelevance Proposition does not take into account the fact that the vast majority of a corporation's shareholders probably believe their stock is worth more than the market price.[179] Thus if they had to sell a few shares to obtain a dividend they would have to sell at what they believed to be a loss. Moreover, most corporations are not likely to have many investment opportunities that yield enough above their current business to justify the added risk.[180] The chances are that most companies have some ability to expand the existing enterprise without increasing risk, but that many opportunities that could yield more would, if invested in, depress the price of the company's stock. The leftover cash would be worth more as cash. Other things being equal, the shareholder would rather have it than let the corporation keep it. And the only way he can get all of it is through a dividend. Viewed from a slightly different angle, one might say that dividends are the shareholders' only means of participating in the unrealizable excess-over-market value since dividends are the only way the shareholder can get cash and not have to forgo the excess.

If one accepts the proposition that shareholders can legitimately disagree with the value placed on their investment by the market, then clearly management's decision to grow or to pay dividends is central to a shareholder's decision to invest in a particular stock.[181] Indeed the complexity of the management decision and the legitimacy of disagreement about it strongly support the notion that investors can disagree as to the correct value of a share of stock.

Thus, both a growth policy and a dividend policy are legitimate corporate objectives. The choice between them is a matter in which shareholders have a direct enough interest to justify some level of intervention in the directors' sphere of authority, as for example, when dividends are not paid even though no investment opportunities exist. Nevertheless, both the majority and the minority as shareholders, as opposed to fiduciaries, may, within the terms of the bargain, act in their own self-interests.

The business purpose doctrine contemplates precisely such situations in which satisfying everyone with a single dividend policy is impossible. In

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178. *See supra* note 169.

179. *See supra* text accompanying note 66; J. WILLIAMS, THE THEORY OF INVESTMENT VALUE 11-41 (1938).

180. *See* J. WESTON & E. BRIGHAM, *supra* note 151, at 796-801.

181. *Id.* at 800-01; W. KLEIN, *supra* note 128, at 256-58.

such cases majority rule and the privilege to vote selfishly are perfectly appropriate.[182] Functionally, the business purpose approach fits the situation by giving the majority free reign to promote its own interest as long as unnecessary damage is not done to the minority.[183] The name, unfortunately, obscures the nature of the rule.

Freeze-outs may be viewed as quite similar to disputes over dividends. To simplify the circumstances greatly, freeze-outs arise when the majority thinks the company is worth more than the minority does. Otherwise, the majority would not be willing to buy out the minority, and certainly not at a premium.[184] Since shareholders value dividends, the reason for the dispute must be that the majority perceives less risk or a higher return than the minority does.[185] The minority disagrees with the majority: the minority believes that for the amount of risk taken, dividends should be greater.

In effect, the majority is in violation of the bargain with shareholders by retaining equity unjustifiably to the extent that it is able to pay higher dividends. What distinguishes the freeze-out, however, is that when cash is available to buy out the minority, no need arises to choose between the objectives of the majority and the minority. The minority can have its dividend, albeit in the form of a cash-out, and the majority can have its investment program. Given the chance, shareholders would agree to unequal treatment under these circumstances.

The business purpose doctrine thus would seem to require that a minority be frozen out when indicated and possible. The use of the doctrine in *Singer* to make freeze-outs more difficult was, in retrospect, curious. In truth, the doctrine was misapplied. The burden placed on the defendants was considerably greater than in other applications. Insiders were generally required to show a compelling purpose and not simply a legitimate objective, which, until the decision in *Weinberger v. UOP, Inc.*, led to judicial blindness to the most important aspects of legitimately competing shareholder interests.[186] The courts had in effect required that the majority demonstrate that it was being positively harmed by the minority, but the most that should have been demanded was a showing that the majority was doing no harm to the minority.[187] As the Delaware Supreme Court recognized in *Weinberger*, business purpose always exists in the context of a freeze-out.[188] At most the business purpose doctrine tells us, indirectly, that inasmuch as one side must win, it is appropriate when possible to ensure that the loser is treated fairly.[189]

182. *See supra* text accompanying notes 60-73.
183. *See supra* text accompanying note 115.
184. *See* Tanzer v. International Gen. Indus., Inc., 402 A.2d 382, 394 (Del. Ch. 1979).
185. *See supra* note 66.
186. 457 A.2d at 715; *see* Brudney & Chirelstein, *supra* note 14, at 1375-76; Easterbrook & Fischel, *supra* note 15, at 725; Weiss, *supra* note 80, at 667-71.
187. *See supra* note 57.
188. 457 A.2d at 715; *see* Weiss, *supra* note 80, at 671 n.300.
189. *See supra* text accompanying note 115.

The duty to pay dividends, and the occasional duty to freeze-out a minority, suggest a corollary duty to sell a business when someone bids more than the majority's perceived value. Debate abounds as to whether third-party sale value should figure in a court's review of the fairness of a freeze-out.[190] In the case of a successfully defended takeover bid, one will never know with certainty how much the insiders thought the corporation was worth. The duty to sell out would thus be unenforceable. Little need for requiring a sale would be present, however, since the manager would have a powerful self-interest, both monetary and professional, in selling a company for more than its value.

When the candidate for sale is a firmly controlled subsidiary, however, the parent may attempt to pay less in a freeze-out than it could get from a third party in order to appropriate to itself a portion of the value of the company represented by the minority shares.[191] Under the new regime established by *Weinberger v. UOP, Inc.* in Delaware, the third-party sale value will probably be a factor considered only if the merger is fraudulent and should not lead to awards of higher prices after simple appraisal proceedings in which no fraud has been shown.[192]

The question that remains, however, is whether minority shareholders may compel a cash-out when the majority refuses for no good reason to accept an offer at a price in excess of the value perceived by the majority. To prove that the majority did not regard the subsidiary as more valuable than the offeror did would be extremely difficult, but arguably that would be irrelevant. The rejected offer, if sufficiently in excess of market price, might itself demonstrate either that the majority had behaved irrationally, or that it was arbitrarily refusing to pay dividends. As yet, there is no reason to believe that shareholders who sue on such a theory will prevail, but there is every reason to expect the matter to be litigated vigorously in the future.

V. CONCLUSION

In sum, the business purpose doctrine is closely connected to circumstances in which unequal treatment is permissible in the sense that a controlling shareholder may use his position within limits for his own selfish ends. As a general rule, the limits are situations in which a choice must be made and one of the alternatives is to favor the majority's interest.

Typically, the choice will be forced because management believes that current investment strategy renders the company more valuable than is generally believed. Of course, that is very difficult, if not impossible, to prove since risk alone is a sufficiently subjective factor to allow incumbents

190. *See, e.g.*, Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439 (1981); Mirvis, *supra* note 67. *Weinberger* itself is the latest judicial statement on the question and is potentially a very significant one.

191. *See* Brudney & Chirelstein, *supra* note 4, at 332.

192. *See* 457 A.2d at 703.

to construct a credible case under almost any circumstances. Thus in practice one can only look for evidence of lack of business purpose and that evidence, to be convincing, will tend to be such as shows that less onerous alternative courses of action were possible.

Undoubtedly, the business purpose test can be and sometimes is abused. Attempting to overcome the abuse by balancing personal motivations against business purposes is, however, not appropriate. The rule only applies in those situations in which, as a matter of sound political and economic policy, the personal motivations of a majority shareholder, who happen also to be a fiduciary, should be recognized as legitimate.